# Regulatory and Enforcement Alert

## The Day Has Come: The SEC Adopts Private Fund Adviser Rules

August 24, 2023

### Introduction

In a 3-2 vote yesterday, the SEC adopted new and amended rules that will substantially augment the regulation of investment advisers to private funds ("Private Fund Adviser Rules" or "Rules").[1] The final version of the Rules contains some significant modifications from the rules that were proposed in February 2022 (the "Proposal"). The Private Fund Adviser Rules do not adopt the most aggressive substantive regulations that would have greatly impacted the private equity industry. Rather, they generally focus more on disclosure and reporting obligations, and impose restrictions and disclosure requirements with respect to certain activities instead of outright prohibitions on such activities.

Most notably, the SEC did not adopt the rule-based prohibition on indemnification of the fund manager contemplated in the Proposal, which would have prohibited an investment adviser from being indemnified for liability including for negligence or gross negligence.

The final Rules have many onerous prescriptions, however. For example, an adviser will be required to offer preferential liquidity rights and transparency rights to all limited partners, if offered to one limited partner and if those rights would have materially negative impacts on other limited partners. Private equity and hedge fund sponsors will need to pay close attention to this requirement, in particular, as such conclusion is judged by an objective "reasonableness" standard. Other preferential side letter terms must be disclosed to current investors, and in some circumstances, to prospective investors.

Furthermore, while the Proposal would have prohibited advisers from reducing the amount of any adviser clawback by taxes paid or to be paid by the adviser, the Private Fund Adviser Rules permit such clawback determinations subject to certain disclosure requirements. Finally, the Rules provide some clarification and flexibility regarding implementation of restrictions and prohibitions, especially as compared to the Proposal.

These changes from the Proposal are mostly welcome, but the Private Fund Adviser Rules will still impose substantial obligations and costs on advisers to private funds, which are exacerbated by vagueness of key terms in

[1] The Private Fund Adviser Rules adopting release and Fact Sheet are posted on the SEC website.

the Rules and operational challenges that will accompany advisers' implementation of these Rules. By relying on Section 211(h) of the Investment Advisers Act of 1940, as amended ("Advisers Act"), a provision which was added to the Advisers Act with the intention of protecting retail investors and distinguishing the standards of conduct for investment advisers from broker-dealers, the Private Fund Adviser Rules are based largely on questionable statutory authority that we expect will subject them to litigation.

While advisers will generally have 12 to 18 months before they must comply with these requirements (as discussed below), advisers should use this time to develop best practices since we expect the SEC staff will seek to vigorously examine for and enforce these requirements promptly after the compliance dates.

## Summary of the Private Fund Adviser Rules

The Private Fund Adviser Rules apply to investment advisers to private funds, which are defined as funds that would be investment companies but for the exclusion from the definition of investment company in Section 3(c)(1) or 3(c) (7) of the Investment Company Act of 1940, as amended, except the Rules do not apply with respect to advisers to securitized asset funds that they advise (which includes collateralized loan obligations (CLOs), among other funds). As detailed below, certain of these provisions apply only to investment advisers that are registered or required to be registered with the SEC ("RIAs"), whereas other provisions apply to all private fund investment advisers, whether SEC-registered, state-registered, un-registered, or Exempt Reporting Advisers ("ERAs").[2]

The Private Fund Adviser Rules are comprised of rules related to reporting, restricted activities, and preferential treatment. The Rules have varying compliance periods, which will begin when the Rules are published in the Federal Register. The SEC also amended the Advisers Act books and records rule to require RIAs to retain specified materials related to certain of these provisions. Each of these provisions are discussed herein.

### I. REPORTING

The Rules' reporting provisions, which apply to RIAs, require RIAs to private funds to:

- ***Provide investors with quarterly statements detailing information regarding private fund performance as well as fees and expenses***. The fee and expense information must include any compensation paid or allocated to the adviser or its related persons by the fund, and any compensation paid or allocated by the fund's underlying portfolio investments. With respect to fund performance, the Private Fund Adviser Rules require advisers to provide performance metrics that are standardized and cover specified periods, both of which vary depending on whether the adviser determines that the private fund is a "liquid" or "illiquid" fund, as defined in the Rules. For illiquid funds, the Rule requires that performance is calculated both with and without the impact of fund-level

[2] The SEC will continue to apply the historical approach that most substantive provisions of the Advisers Act do not apply with respect to non-U.S. funds managed by offshore RIAs or offshore ERAs (*e.g.*, the quarterly statement rule, audit rule, adviser-led secondaries rule), even if these non-U.S. funds have U.S. investors.

subscription facilities (*i.e.*, levered and unlevered returns) and without the inclusion of the adviser or its affiliates investment in the fund; this is a change from the Proposal, which would have required performance for illiquid funds to be shown only without the impact of subscription lines. RIAs must retain (i) a copy of quarterly statements and each addressee to whom they were provided, (ii) records evidencing all calculation methodologies, and (iii) records evidencing its determination of whether each fund is liquid or illiquid.

With respect to the timing for providing[3] quarterly statements, if the private fund is not a fund of funds, then a quarterly statement must be distributed ***within 45 days*** after the end of each of the first three fiscal quarters of each fiscal year and ***90 days*** after the end of each fiscal year.[4] For a private fund that is a fund of funds, a quarterly statement must be provided within ***75 days*** after the first, second, and third fiscal quarter ends, and ***120 days*** after the end of the fiscal year of the fund of funds;

- ***Obtain an annual audit for each private fund***. The Rules require RIAs to obtain an annual financial statement audit of each private fund that they directly or indirectly advise. In a notable change from the Proposal, an audit will comply with the final Rules requirement if it is conducted in accordance with the audit provision (and related requirements for delivery of audited financial statements) under the current Custody Rule (Rule 206(4)-2 under the Advisers Act), and it appears that SEC staff guidance and FAQs related to the Custody Rule audit provision would also be applicable to the audit required by the Private Fund Adviser Rules.[5] RIAs must maintain a copy of each private fund's audited financial statements. The adopting release asserts that the audit provision could provide a check on the adviser's valuation of private fund assets (and ultimately on the adviser's fees); this assertion is consistent with the SEC's recent focus on valuation of private fund assets.[6]; and
- ***Obtain a fairness opinion or valuation opinion in connection with an adviser- or GP-led secondary transaction***. The final Rules require RIAs to obtain a fairness opinion or a valuation opinion from an independent third party in connection with adviser-led secondary transactions. This is a change from the Proposal, which would have mandated a fairness opinion. Certain transactions, including transactions involving investments in a continuation fund, clearly meet the definition[7] of "adviser-led secondary transaction." However, as stated in the adopting release, tender offers generally will not be

[3] Electronic delivery is effective provided it is made in accordance with SEC guidance on electronic delivery, meaning reports can be posted to a dataroom if the adviser gives prior notification to investors.

[4] For newly formed funds, advisers are required to provide these performance metrics after the first two full quarters of operating results for the fund. There is no exception for "not meaningful" performance.

[5] Because this audit requirement could have implications on the Custody Rule audit provision, the SEC has re-opened the comment period for the Safeguarding Rule that it proposed in February 2023. The comment period for the Safeguarding Rule proposal will remain open for 60 days after the notice of the comment re-opening is published in the Federal Register. *See* https://www.sec.gov/news/press-release/2023-156.

[6] *See* Simpson Thacher Client Alert, "SEC Steps Up Private Funds Enforcement With Insight Partners Fee Calculation Settlement," (June 21, 2023).

[7] Rules define GP-led secondary transactions as transactions initiated by the investment adviser or its related persons that offer investors the choice between selling all or a portion of their interests in the private fund and converting and exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or its related persons.

covered by the definition of "adviser-led secondary transaction," while the determination whether other types of transactions fall within the definition of "adviser-led secondary transaction" will be based on the relevant facts and circumstances. RIAs must also prepare a written summary of any material business relationships between the adviser and its related persons and the independent opinion provider within the two-year period immediately prior to the date that the fairness opinion or valuation opinion is issued. The fairness or valuation opinion and the summary any material business relationships must be distributed to private fund investors prior to the due date for investors to submit the election form. RIAs must retain a copy of fairness opinion or valuation opinion and the material business relationship summary, as well as a record of each addressee to whom these materials were distributed and the date of distribution.

## II. RESTRICTED ACTIVITY

The restricted activity provisions, which apply to RIAs and ERAs, restrict private fund advisers in certain fundamental respects, subject to consent-based and/or disclosure-based exceptions. As a result, these activities are not flatly prohibited, as they would have been under the Proposal, as long as advisers provide appropriate disclosure and in some cases obtain investor consent.[8]

- ***Regulatory, Compliance and Examination Expenses***. Advisers are prohibited from charging or allocating to the private fund regulatory, examination, or compliance fees or expenses of the adviser, unless such fees and expenses (including the dollar amounts thereof) are disclosed to investors. Therefore, advisers must disclose if they are charging or allocating to the private fund regulatory, examination, or compliance fees or expenses of the adviser. Disclosure is required within 45 days after the fiscal quarter in which the fees or expenses were incurred.
- ***Investigation Expenses***. Advisers must disclose and obtain consent from fund investors if the adviser charges or allocates to the private fund any fees or expenses associated with an investigation of the adviser. However, an adviser may not charge fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Advisers Act or the rules promulgated thereunder.[9]
- ***Reducing Adviser Clawbacks for Taxes***. Advisers are restricted from reducing the amount of an adviser (or affiliate) clawback by the amount of certain taxes unless the post-tax clawback is subject to after-the-fact disclosure. Specifically, an adviser must disclose, in a written notice to the investors of the impacted private fund, the aggregate dollar amounts of the adviser clawback both before and after the

[8] The consent-based exceptions will require consent from fund investors (and *not* LPACs, advisory boards or boards of directors). Advisers will be required to seek consent from all of a fund's investors and obtain consent from at least a majority in interest of investors that are not related persons of the adviser.

[9] An adviser may charge a private fund client for fees and expenses associated with an investigation by the SEC for a potential violation the Advisers Act; however, if the investigation results in a court or governmental authority finding against the adviser or its related persons, then the adviser must refund the fund for the fees and expenses associated with the investigation, such as lawyer's fees.

reduction of the clawback for actual, potential, or hypothetical taxes. The notice must be provided within 45 days after the end of the fiscal quarter in which the adviser clawback occurs.

- ***Certain Non-Pro Rata Fee and Expense Allocations***. An adviser is prohibited from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by it or its related persons have invested (or propose to invest) in the same portfolio investment unless (i) the allocation approach is fair and equitable, and (ii) the adviser distributes to fund investors advance written notice of the non-pro rata charge and a description of how the allocation approach is fair and equitable under the circumstances.
- ***Borrowing From Private Fund Clients***. Advisers are prohibited from borrowing or receiving an extension of credit from a private fund client without disclosure to, and consent from, fund investors. Advisers must distribute a written notice and a description of the material terms of the borrowing (e.g., the amount of money to be borrowed, the interest rate, and the repayment schedule) to the investors of the private fund and must seek and obtain written consent from at least a majority in interest of the fund's investors that are not related persons of the advisers.

## III. PREFERENTIAL TREATMENT

The Rules prohibit RIAs and ERA from providing preferential liquidity (*i.e.*, redemption rights)[10] or informational rights that the adviser reasonably expects to have a material negative effect on fund investors, unless this treatment is offered to other investors in the private fund and any similar pool of assets, and prohibit other types of preferential treatment, unless preferential material economic terms are disclosed in advance of an investor's investment in the private fund and all preferential terms are disclosed after the investor's investment.[11] The Private Fund Adviser Rules require the adviser to distribute to prospective investors, prior to an investor's investment in the fund, and to current investors a written notice of all preferential treatment the adviser or its related persons has provided to other investors in the same private fund (i) for an illiquid fund, as soon as reasonably practicable following the end of the fund's fundraising period and (ii) for a liquid fund, as soon as reasonably practicable following the investor's investment in the private fund. RIAs must document compliance with the disclosure and consent requirements, as applicable, including a copy of any notification, consent, or other document distributed to or received from private fund investors along with a record of each addressee and the date of distribution.

[10] An adviser is permitted to allow an investor to redeem if such redemption right is required by law applicable to the investor, fund or similar pool of assets.

[11] The SEC limited the advance written notice requirement to prospective investors to apply only to material economic terms, but advisers are still required to provide to current investors comprehensive, annual disclosure of all preferential treatment (including non-economic terms) provided by the adviser or its related persons since the last annual notice.

## IV. ADDITIONAL CONSIDERATIONS

***Compliance Date and Legacy Status for Existing Private Funds***. The compliance dates for the Private Fund Adviser Rules vary, depending on the particular requirements. Specifically, the compliance date for the requirements for private fund audits and quarterly reporting statements for fund investors is ***18 months*** from date that the Private Funds Rule is published in the Federal Register. The compliance dates for the requirements related to preferential treatment, restricted activities, and adviser-led secondary transactions are staggered depending on the amount of an adviser's assets under management: ***12 months*** after publication in the Federal Register for advisers with $1.5 billion or more in private fund assets under management ("larger private fund advisers"), and ***18 months*** after publication for advisers with less than $1.5 billion in private fund assets under management ("smaller private fund advisers").

In addition, the Private Fund Adviser Rules provide legacy status, but only with respect to certain funds and only for certain Rule requirements. Specifically, legacy status is available with respect to the practices that are covered by the preferential treatment prohibition and certain restricted practices that require investor consent. The legacy status provisions apply to a governing agreement that was entered into prior to the compliance date for the applicable Rule provision if it would require the parties to amend the agreement, provided that the relevant private fund had commenced operations[12] as of the compliance date.

***Amendment to Advisers Act Compliance Rule***. As part of this rulemaking, the SEC also amended Rule 206(4)-7 under the Advisers Act (the "Compliance Rule") to require all RIAs to document in writing their annual review of their compliance policies and procedures. This amendment to the Compliance Rule does not mandate a particular form or format for the RIA's documentation of its compliance policies and procedures, and as noted in the adopting release, many RIAs already document, in some manner, their reviews of their compliance policies and procedures. Significantly, this amendment applies to all RIAs, including those that do not advise private funds, and has the earliest compliance date of all the requirements adopted in this rulemaking—***60 days*** after the Rules are published in the Federal Register.

## Conclusion

While the SEC's final Rules did not proceed with some of the most burdensome proposals, the final Rules will still result in significant burdens on advisers to private funds. The Private Funds Rule must also be viewed in conjunction with the SEC's expansive rulemaking activity generally and for private funds in particular, and the cumulative impact of this rulemaking activity on investment advisers, particularly small and emerging advisers, will be substantial. Some of the Rules are vulnerable to challenges in litigation based on, among other things, the questionable statutory basis for the Rules.

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[12] According to the Rule release, the requirement that the fund has commenced activities is intended to prevent advisers from conduct that the SEC believes would be an abuse of this legacy status provision. The commencement of operations include bona fide activity directed toward operating a private fund, including investment, fundraising, or operational activity such as issuing capital calls, setting up a subscription activity for the fund, holding an initial fund closing, conducting due diligence on potential fund investments, or making an investment on behalf of the fund.

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